

Message Text

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INFO OCT-01 EB-07 SS-15 ISO-00 CCO-00 SSO-00 /026 R

DRAFTED BY L/EB:PRTRIMBLE:JO/SB

APPROVED BY EA - MR. HABIB

L - MR. LEIGH

EB - MR. GREENWALD

EB - JLKATZ

EA/EP - AGEBER

S/S - MR. BORG

S-RWAHERNE

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P 241811Z APR 76 ZFF4

FM SECSTATE WASHDC

TO USDEL SECRETARY PRIORITY

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FOR SECRETARY THRU ROBINSON FROM LEIGH, HABIB, GREENWALD

E.O. 11652: N/A

TAGS:OVIP (KISSINGER, HENRY A.) ID, EFIN, ENRG,EINV

SUBJECT: ACTION MEMORANDUM (S/S NO.7608593) IRS RULING
ON OIL SHARING CONTRACTS

1. THE INTERNAL REVENUE SERVICE IS PREPARING TO PUBLISH A
RULING DENYING A U.S. TAX CREDIT FOR TAXES PAID BY OIL
COMPANIES TO INDONESIA UNDER PRODUCTION SHARING CONTRACTS.
THIS RULING MAY HAVE IMPLICATIONS WELL BEYOND INDONESIA.

2. IT IS A DEPARTURE FROM PRIOR IRS POLICY IN THIS AREA.
THE CHANGED POLICY WOULD TREAT PRODUCTION SHARING CONTRACTS
LESS FAVORABLY THAN CONCESSION AGREEMENTS, THEREBY APPEAR-
ING TO DISCRIMINATE AGAINST INDONESIA (AS OPPOSED TO THE
MIDDLE EAST) AND CREATING DISINCENTIVES TO USE PRODUCTION
SHARING CONTRACTS (WHICH THE USG FAVORS AS AN ATTRACTIVE
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ALTERNATIVE TO TRADITIONAL EQUITY INVESTMENT APPROACHES

IN LDCS).

3. IT WILL OBVIOUSLY CHANGE THE ECONOMIC EFFECT OF EXISTING PRODUCTION SHARING CONTRACTS, WHICH WERE ENTERED INTO ON THE ASSUMPTION THAT THE FOREIGN TAXES COULD BE CREDITED AGAINST U. S. TAX. THIS CHANGE SEEMS CLEARLY UNFAIR, AND COULD HAVE A SERIOUS ADVERSE EFFECT ON SOME OF THE INDEPENDENT OIL COMPANIES. IT COULD ALSO UNDERMINE THEIR COMPETITIVE POSITION VIS-A-VIS FOREIGN COMPANIES WHOSE HOME GOVERNMENTS PERMIT A TAX CREDIT OR SIMILAR BENEFIT, AND IT COULD FORCE RENEGOTIATION OF EXISTING CONTRACTS OR CURTAILMENT OF PRODUCTION MADE UNECONOMIC BY THE NEW TAX RULE. THE LATTER RESULT COULD CARRY IMPLICATIONS FOR OUR POLITICAL RELATIONS WITH INDONESIA AND OTHER AFFECTED GOVERNMENTS WHO MAY SEE THE IRS RULING AS A CHANGE IN THE RULES OF THE GAME BY THE USG.

4. MOST OF THE ADVERSE IMPLICATIONS WOULD BE AVOIDED IF THE IRS RULING WERE MADE PROSPECTIVE SO THAT IT IS APPLICABLE ONLY TO CONTRACTS ENTERED INTO IN THE FUTURE. THIS WOULD PERMIT FUTURE CONTRACTS (AND CONCEIVABLY INDONESIAN LAW) TO BE DRAFTED TO MEET IRS REQUIREMENTS.

5. WE ALSO BELIEVE THAT WE SHOULD TAKE THIS OCCASION TO REQUEST TREASURY TO PROVIDE A MEANS BY WHICH THE STATE DEPARTMENT CAN MAKE ITS VIEWS KNOWN IN ADVANCE WHEN TREASURY IS CONSIDERING CHANGES IN TAX POLICY WITH FOREIGN POLICY CONSEQUENCES.

6. RECOMMENDATION:

THAT YOU AUTHORIZE THE DEPARTMENT TO SEND THE ATTACHED LETTER IN YOUR NAME TO SECRETARY SIMON POINTING OUT THE FOREIGN POLICY IMPLICATIONS OF THE RULING AND ASKING HIM TO TAKE THEM INTO ACCOUNT, AND TO PROCEED IN THE FUTURE BY REGULATION OR OTHER MEANS IN WHICH THE STATE DEPARTMENT CAN MAKE ITS VIEWS KNOWN ON CHANGES IN TAX POLICY WITH DIRECT AND SIGNIFICANT FOREIGN POLICY IMPLICATIONS.

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APPROVE DISAPPROVE

7. PROPOSED LETTER TO SECRETARY SIMON:

QUOTE DEAR BILL:

I UNDERSTAND THAT THE INTERNAL REVENUE SERVICE HAS INDICATED THAT IT PROPOSES TO DENY U.S.TAX CREDITS

FOR PAYMENTS TO INDONESIA UNDER OIL PRODUCTION SHARING AGREEMENTS. I HAVE ALSO BEEN ADVISED THAT THIS REPRESENTS A CHANGE IN APPROACH WHICH WILL SIGNIFICANTLY ALTER THE ECONOMIC EFFECT OF PRODUCTION SHARING ARRANGEMENTS.

I AM CONCERNED THAT THERE MAY BE FOREIGN POLICY IMPLICATIONS OF THIS CHANGE WHICH SHOULD BE CONSIDERED. IT WOULD NOT APPEAR TO BE DESIRABLE FROM A FOREIGN POLICY POINT OF VIEW TO DISCOURAGE EXPANDED PRODUCTION IN INDONESIA, AS OPPOSED TO OTHER PRODUCING AREAS, OR TO DISCOURAGE THE USE OF PRODUCTION SHARING CONTRACTS, WHICH WE HAVE ENCOURAGED AS AN ALTERNATIVE TO TRADITIONAL EQUITY INVESTMENTS IN LDCS, BY ESTABLISHING TAX DISINCENTIVES VIS-A-VIS THE ALTERNATIVES. IN ADDITION, THE PRACTICAL EFFECT OF THE REVISED APPROACH COULD BE TO FORCE RENEGOTIATION OF EXISTING CONTRACTS OR CURTAILMENT OF PRODUCTION OR EXPLORATION IN INDONESIA OR OTHER COUNTRIES WHO MAY HAVE SIMILAR CONTRACTUAL ARRANGEMENTS, WHICH IN TURN CAN HAVE A FOREIGN POLICY EFFECT.

I HOPE THAT YOU WILL BEAR THESE CONSIDERATIONS IN MIND, PARTICULARLY AS TO WHETHER THE REVISED APPROACH COULD BE MADE APPLICABLE ONLY TO CONTRACTS HEREAFTER ENTERED INTO, AN APPROACH WHICH AT LEAST COULD MITIGATE THE LATTER SET OF PROBLEMS. FURTHER, TO THE EXTENT THAT CHANGES ARE CONSIDERED IN FOREIGN TAX CREDIT POLICY OR OTHER TAX POLICY HAVING DIRECT AND SIGNIFICANT FOREIGN POLICY IMPLICATIONS, I HOPE THAT YOU WILL CONSIDER PROCEEDING BY REGULATION OR IN SOME OTHER MANNER IN WHICH THE DEPARTMENT OF STATE CAN MAKE ITS FOREIGN POLICY VIEWS KNOWN.

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WARM REGARDS, HENRY A. KISSINGER. END QUOTE

CLEARED BY: L - MR. LEIGH
EB - MR. KATZ
EB - MR. GREENWALD
EA - MR. GEBER
S - AHERNE

SISCO

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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: TOSEC, POLICIES, PETROLEUM INDUSTRY, TAXES, PROFIT SHARING, DIPLOMATIC COMMUNICATIONS
Control Number: S7608593
Copy: SINGLE
Draft Date: 24 APR 1976
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: ShawDG
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1976STATE100004
Document Source: CORE
Document Unique ID: 00
Drafter: PRTRIMBLE:JO/SB
Enclosure: n/a
Executive Order: N/A
Errors: N/A
Film Number: D760156-0839
From: STATE
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1976/newtext/t19760424/aaaaaunw.tel
Line Count: 163
Locator: TEXT ON-LINE, ON MICROFILM
Office: ORIGIN L
Original Classification: LIMITED OFFICIAL USE
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 3
Previous Channel Indicators: n/a
Previous Classification: LIMITED OFFICIAL USE
Previous Handling Restrictions: n/a
Reference: n/a
Review Action: RELEASED, APPROVED
Review Authority: ShawDG
Review Comment: n/a
Review Content Flags:
Review Date: 22 JUL 2004
Review Event:
Review Exemptions: n/a
Review History: RELEASED <22 JUL 2004 by BoyleJA>; APPROVED <04 NOV 2004 by ShawDG>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
04 MAY 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: ACTION MEMORANDUM (S/S NO.7608593) IRS RULING ON OIL SHARING CONTRACTS
TAGS: OVIP, EFIN, ENRG, EINV, ID, US, (KISSINGER, HENRY A), (SIMON, WILLIAM E),
To: SECRETARY
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 04 MAY 2006